18TH ANNUAL CALIFORNIA TAX POLICY CONFERENCE
PASS THROUGH ENTITIES
(LIMITED LIABILITY COMPANIES COME OF AGE)

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18TH ANNUAL CALIFORNIA TAX POLICY CONFERENCE

PART ONE PRESENTATION (PROFESSOR PHIL WILE)

I have been professionally involved with tax law since 1957 when I was admitted to practice as an attorney in California. For 30 years thereafter I practiced as a tax attorney, living through (1) the years when most profitable businesses were incorporated to reduce the federal and state income taxes on the net income derived from the business (because corporate rates were then significantly lower than individual rates, particularly in the higher brackets) and enable them to build and retain capital needed in the business, through tax savings, (2) the tax shelter craze when shelters with multiple owners were organized as partnerships (usually limited partnerships) and the taxing authorities discovered SOME OF the defects in Subchapter K of the Internal Revenue Code and comparable provisions of state law, and (3) the enactment and initial years of the 1986 Act, which significantly changed tax practice, particularly as it relates to tax practice.

In 1987, I left practice and became a law professor hired to teach tax law. Because no one on the faculty at my law school would even consider teaching partnership and Subchapter S taxation, and I was the "new kid on the block," I got the assignment. I have now taught partnership and Subchapter S tax law for 15 years, living through the flood of increasingly complex legislation and administrative interpretations of the federal and state tax law applicable to partnerships and S corporations. By now I am quite ready to frankly admit that the law and regulations governing the tax treatment of partnerships and their partners, in the relevant statutes and regulations, is, much of it, beyond reasonable comprehension, impossible to teach and learn, and even more impossible to remember. But my students and I continue to try, with varying degrees of success. On the other hand, with a few minor exceptions, I am able to understand and teach the tax law that applies to S corporations, good or bad, and my students are generally capable of understanding, learning, and remembering it. All of this has undoubtedly jaded my outlook as to the choice between a partnership or limited liability company ("LLC") and an S corporation as the appropriate tax entity for a business enterprise with two or more owners. You will note that I have limited the choices to exclude a C corporation. I totally reject use of a C corporation as the appropriate business entity for a closely held business in all but a few situations. Most of these involve businesses that are not highly profitable in which those responsible for the business can be paid reasonable compensation that reduces the taxable profit to a very small amount, thus essentially avoiding the double tax on the income of a C corporation. I have heard such an entity referred to as a "practical S corporation," as a C reorganization is often called a "practical" merger. But the plan seems to me to be an example of making tax planning overly difficult.

During my 15 years as a teacher of partnership and S corporation tax law, LLC legislation has been adopted in all 50 states and LLCs have become the rage. Why? Obviously they offer limited liability to the owners of the business and tax treatment as a partnership, thus avoiding the "double tax" on the income of the business if it were conducted in a C corporation, **and**, I suspect, because now, as was once the case with tax shelter investments, many business and professional people are apparently embarrassed to appear at a cocktail party or other social gathering without being able to talk about their LLC.

With this background, I suspect you will not be surprised to learn that I do not agree with Don Alexander, for whom, incidentally, I have the greatest respect. With a few significant exceptions that I will explain, I believe no rational, reasonably well-informed tax professional would advise his or her clients to organize a new business enterprise with two or more owners as an LLC and elect partnership tax treatment, where Subchapter S was available. Why? Primarily because of the complexity and resulting costs of properly organizing and operating an LLC. I am cognizant of the possibility of forming an LLC and having it elect corporate tax treatment and make an election to be governed by Subchapter S. But, in most cases at least, that seems an unnecessarily complicated way to create an S corporation.

Obviously where the business has only a single owner and there is no thought of admitting another owner, the concern with respect to the application of the partnership tax laws is not relevant. I largely agree with Don Alexander's comment where the business has and will have only a single owner, with one significant qualification. Before choosing an LLC for a one-owner business, consideration must be given to the annual tax and fees that apply in California and some other states to LLCs.

In recent years, the popularity of LLCs, the continuing criticism and dissatisfaction with the double tax on earnings of C corporations, and the never-ending complexity of the tax law applicable to partnerships, has led a number of academics and practitioners in the tax field to devote considerable time and thought to the present structure of our federal and state tax systems as they apply to business enterprises, and how they could be improved. The solutions offered to date number almost as many as there are persons suggesting them. But there seems to be a general consensus that the tax treatment of smaller businesses (identified under some undefined standard based on revenue or ownership or a combination of the two) should be different from the tax treatment of large business enterprises (similarly identified). Primarily the effort has been to make the tax law applicable to smaller business enterprises simple enough that it can be understood and applied by taxpayers and their advisors and tax administrators alike, without excessive cost. Many, of which I am one, believe the model for this should be subchapter S, with some modifications, not subchapter K. With respect to large business enterprises, the debate has centered on the "double tax" and various possibilities for integration to eliminate it. Perhaps the most comprehensive of these discussions is Professor George Yin's 1999 article in the Florida Tax Review. Yin, *The Future Taxation of Private Business Firms*, 4 Fla. Tax Rev. 141. His suggestions are that with respect to smaller business enterprises the model should be subchapter S with some modifications and with respect to larger business enterprises it should be subchapter K, with major modifications.

Given the ability that Congress and the California legislature have demonstrated over the last several decades to produce simple, straight-forward, policy-oriented tax legislation, the possibility of major improvements in the structure of our federal and state tax laws governing business enterprises looks remote, at best, to me. So long as our tax laws are driven by partisan politics and campaign contributions, as they have been for many years, particularly in the last decade, I have little hope that the dialog regarding the restructuring of our tax laws applicable to business enterprises will turn out to be more than an academic exercise. In the meantime, we must all live with what we've got. So I want to use the rest of my time to say a few things that may be contrary to the "conventional wisdom" about choice of entity and the use of LLCs under our present tax laws.

WHERE LLCs MAY BE THE BEST CHOICE

I would suggest that the following as good examples of the situations where an LLC is the best choice:

(1) A single-owner business with a significant risk of liabilities and an annual gross income of less than $250,000. The LLC will insulate the owner from personal responsibility for liabilities of the business for which he would be personally liable in a sole proprietorship. In some professional and business activities the existing inability to obtain insurance coverage against such liabilities at a reasonable price or for any price makes the use of an entity affording limited liability to the owner mandatory. Failure to make the election to be taxed as a corporation will allow the LLC to be disregarded for tax purposes, thus permitting it to be treated as a sole proprietorship for tax purposes. As a result, separate tax returns reflecting all of the income and deductions and other tax items of the business will not be required. However, the California tax and fees imposed on LLCs[1] will apply. These additional costs will not be significant; however, if the annual income by which the California fee is measured does not exceed $250,000 and only the $800 annual tax must be paid. Where the business has a large income and large deductions resulting in little or no profit, an S corporation may be a better choice, to avoid the higher fees imposed on LLCs.[2]

(2) A separate division of a large, diversified corporation, to insulate the assets of that division

[1] Under Revenue & Taxation Code §§17941 and 17942. The annual tax is $800 and the annual fee ranges upward from $900 which is imposed on an LLC with an income of $250,000 or more, to $11,790 if the income is $5,000,000 or more. Rev. & Tax. Code §17942(a). "Income" for this purpose means gross income plus cost of goods sold. *Id*. §17942(b)(1).

[2] Under Revenue & Taxation Code §23802 an S corporation is subject to a flat franchise tax computed at 1.5% of its taxable income.

from liabilities incurred in the other divisions or in the parent corporation and to insulate the parent and the other divisions from liabilities of the LLC. Failure to make the election to be taxed as a corporation will allow the single member LLC to be disregarded for tax purposes, thus allowing it to be treated as a part of its parent and separate returns reflecting all of the business's income and deductions will not be required. However, the California tax and fees imposed on LLCs will apply and may make the use of an LLC with respect to some divisions uneconomical.

(3) A multi-owner closely-held business with a significant risk of liabilities, through which the owners seek to take advantage of the flexibility offered by subchapter K and comparable state law that is not available through an S corporation, as, *e.g.*, making "special allocations" of deductions, and the owners are willing and able to pay the additional legal and accounting costs that may be required to obtain that flexibility. Use of the LLC will insulate the owners from liabilities of the business for which they, or some of them, would be personally liable in a partnership.[3] Failure to make the election to be taxed as a corporation will cause the LLC to be treated as a partnership for tax purposes, making subchapter K applicable. However, the LLC will be subject to the California tax and fees imposed on LLCs, which must be considered in making the choice.

(4) A multi-owner closely held business with a significant risk of liabilities and an uncertain future in its new line of business. Use of the LLC will insulate the owners from the liabilities of the business for which they, or some of them, would be personally liable in a partnership. An LLC is preferable to an S corporation or a C corporation because a liquidation of the entity, if that becomes necessary, will not result in taxes imposed at the entity and owner levels on appreciation occurring during the period of operation. Failure to make an election to be taxed as a corporation will cause the LLC to be treated for tax purposes as a partnership, allowing termination of the business and distribution of the LLC's properties with nonrecognition treatment under the rules on partnership liquidations, if that becomes necessary. However, the LLC will be subject to the California tax and fees imposed on LLCs, which must be considered in making the choice. If the operation is successful, it could then be converted to an S or C corporation, without recognition of gain.

(5) A multi-owner closely held business with a significant risk of liabilities and property that is expected to appreciate significantly during an extended period of operation. Use of the LLC will insulate the owners from the liabilities of the business for which they, or some of them, would be personally liable in a partnership. Failure to make the election to be taxed as a corporation will cause the LLC to be treated for tax purposes as a partnership, allowing adjustments in the LLC's basis on property held by the LLC when an owner dies or ownership changes, under a section 754 election. However, the LLC will be subject to the California tax and fees imposed on LLCs, which must be considered in making the choice.

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[3] There is the possibility of avoiding this risk of personal liability through the use of an S corporation as the sole general partner.

The list is illustrative only, and is not intended to be exhaustive.

WHY LLC MAY BE A BAD CHOICE

The factors that may make an LLC a bad choice include:

(1) The complexity of the tax law where failure to make the election to be treated as a corporation for tax purposes will result in the LLC being treated as a partnership, subject to subchapter K and the related California law. This complexity will in many cases significantly increase the costs of organization and operation as compared an S corporation or a C corporation.[4]

(2) Uncertainty in the relatively new state law applicable to LLCs[5] and the federal and state tax law with respect to partnerships.

(3) The significantly higher California tax and fees that apply to LLCs as opposed to S corporations (to which a lower tax applies) or a sole proprietorship (to which no separate tax applies).

The list is illustrative only and is not intended to be exhaustive.

WHY S CORPORATIONS MAY BE A BETTER CHOICE

The factors that may make an S corporation a better choice include:

(1) The relative simplicity and certainty of the tax law applicable to S corporations, as opposed to that in subchapter K, and of the state law on corporations, and the related savings in professional and other expenses.

(2) The availability of opportunities to obtain nonrecognition treatment under federal and state tax laws for an acquisition or reorganization of the business structure.

(3) The significantly lower California taxes that apply to S corporations as compared to the annual tax and fees imposed on LLCs.

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[4] My experience suggests that tax counsel and accountants, more familiar with the law than clients, tend to understate the complexity and associated costs of advising the use of an LLC as the appropriate business entity.

[5] See Gevurtz, *California's New Limited Liability Company Act: A Look at the Good, the Bad, and the Ambitious*, 27 Pacific Law Journal 261 (1996).

The list is illustrative and not intended as exhaustive. It is recognized that the S corporation structure may not be available because of the various limitations imposed on those who may be shareholders of an S corporation.

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PART THREE (ED KLINE)

GENERAL DISCUSSION

Introduction

Limited liability companies represent a significant change in choice of business organization in California, in the other states and the District of Columbia.

Limited liability companies (LLC) are business entities that combine the corporate characteristics of limited liability for all investors, with the pass through attributes of, and flexibility associated with, partnerships or disregarded entities for income tax purposes. Further, LLCs allow business operations to have the limited liability protection of corporations without corporate taxes.

Although LLCs were adopted by many states between 1988 and 1996, there was significant uncertainty regarding their status for tax purposes. In response to the needs of those doing business using one of the new entity forms, as well as those administering taxes, both the IRS and FTB completely revised the way that business entities are classified. The uncertainty was resolved by the adoption of U.S. Treasury Regulations (Treas. Reg.) §§ 301.7701-1, -2, and –3[1], and California Code of Regulations, title 18, (Cal. Code Reg.) §§ 23038(b)-1, -2, and-3[2], effective for taxable years commencing on or after January 1, 1997. Generally, the California regulations conform to the applicable federal regulations. Further, Cal. Code Reg. § 23038(b)-3 requires the California election for tax purposes to be the same as the federal election. It is noted that these regulations do not refer to limited liability companies, but refer to "business entities" in general.

Most LLCs with multiple members choose to be classified as partnerships for both federal income tax and California state franchise and income tax purposes. However, LLCs with multiple members may also choose to be classified as an unincorporated association, taxed as a corporation. An LLC wit a single member will usually choose to be taxed as a disregarded entity, although it may also choose to be

[1] These Treasury Regulations were amended by T.D. 8767, March 23, 1998, T.D. 8827 (corrected October 29,1999) July 9, 1999, T.D. 8844, November 26, 1999, T.D. 8970, December 14, 2001, and T.D. 9012, July 31, 2002.

[2] The California regulations have not yet been modified to conform to the changes to the Treas. Reg Regulations sections 301.7701-1, -2, and –3, but a regulation project is in process to consider adopting these modifications.

classified as an unincorporated association, taxed as a corporation. An LLC may elect to change its election, but then may not change again for 60 months.

An LLC is a legal entity created under state law or under the laws of another country. An LLC must file articles of organization with the Secretary of State of California, or if organized outside of California, register with the Secretary of State to do business in California. The entity is separate from its owners. It owns property, incurs debts, enters into contracts, and can sue or be sued. Members are shielded from the entity's liabilities, but are not protected from liability to third parties for the member's tortuous acts such as fraud. No member is required to have the general liability of a general partner. Members of an LLC are permitted to be active in the business of an LLC while retaining limited liability.

In order to organize a business as an LLC, Articles of Organization are filed in accordance with California Corporations Code section 17000 et sq., the Beverly-Kiea Limited Liability Company Act. The governing instrument is known as an operating agreement, and the owners of the entity are called "members."

The name of the entity must include language that puts the public on notice that there is limited liability, such as "Limited," or "LLC."

There are no ownership restrictions and there is no limit, maximum or minimum, to the number of members that may own a single LLC.

Unanimous or majority consent of all members may be required before an LLC interest can be transferred.

Death, retirement, resignation, expulsion, or bankruptcy of any member generally results in dissolution unless remaining members agree to continue the business.

An LLC may be managed by all of its members, or one member, and may designate certain persons as managers. The manager need not be a member of the LLC.

LLCs are particularly well suited to hold real property, and that currently appears to be the largest single use of LLCs in California, approximately 45%.

Please see the table attached hereto, which compares the LLC to a limited partnership, a general partnership, a limited liability partnership, and a corporation.

<u>Federal and California Income and Franchise Tax Classification- "Check-the-Box"</u>

Treas. Reg. § 301.7701-1 and Cal. Code Reg. § 23038(b)-1 provide an overview of the business entity "check-the-box" regulations.

Classification for tax purposes does not affect the rights and obligations of an entity's owners under local law. For example, a single-owner LLC may be disregarded for tax purposes. Reporting the activity of the business as a proprietorship on an individual income tax return does not negate the limited liability granted to the LLC under California state law.

Treas. Reg. § 301.7701-2 and Cal. Code of Regs. § 23038(b)-2 set out the business entities that are considered corporations for federal and California tax purposes. For federal income tax and California franchise tax purposes, the term "corporation" always means:

1. A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;

2. An association (as determined under Treas. Reg. § 301.7701-3 and Cal. Code Reg. § 23038(b)-3.);

3. A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint stock association;

4. An insurance company;[3]

5. A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute;

6. A business entity wholly owned by a State or any political subdivision thereof;

7. A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and

8. Certain listed foreign entities. The regulation lists 80 foreign entities that will always be treated as corporations and describes certain foreign entities (Treas. Reg. § 301.7701-2(b)(8)(ii) and (d)) lists exceptions to the foreign entity list. Proposed changes to Treas. Reg. § 7001-2 provide some clarification to the foreign entities list.

Any business entity that is not required to be treated as a corporation may choose its classification under the rules of Treas. Reg. § 301.7701-3 and Cal. Code Reg. § 23038(b)-3. <u>The election must be the same for federal and state purposes</u>. An eligible entity with at least two members can be classified either as a partnership or as an association taxable as a corporation. An entity with a single member can

[3] Cal. Code Reg. § 23038(b)-2(b)(4) through (6) does not list these federal classifications, but reserves items 4, 5, and 6.

be classified as an association taxable as a corporation or can be disregarded as an entity separate from its owner. For example, a single member entity owned by a corporation would report operations as if the entity were a division or branch of the parent corporation or would elect to be taxed as a corporation. A single member entity owned by a natural person would be treated as a proprietorship or would elect to be taxed as a corporation.

The regulations assume that most domestic entities with at least two members will want to be classified as partnerships. Those with one member will likely want to disregard the entity for tax purposes. The regulations provide default classification rules that match these expectations. No action is required if an entity wishes to be treated as a partnership or disregarded.

Change in Classification

If an entity wishes to change from the default classification, it must file Form 8832, Entity Classification Election, used for both federal and California state purposes.. The election must be signed by each member of the entity or any officer, manager, or member of the entity who is authorized to make the election and who represents to having such authorization under penalties of perjury.

Generally, an entity cannot change its classification again until 60 months after the effective date of the former election.

Changes between corporation and partnership tax status will have tax consequences that must be reported. The tax treatment of a change in the classification of an entity for federal and California tax purposes is determined under all the relevant provisions of the Internal Revenue Code and California Revenue and Tax Code, and general principles of tax law, including the step transaction doctrine. For example, if an organization, which elected to be taxed as a corporation, decided to change to a partnership, the organization and its owners would have to follow all of the rules applicable to liquidations of corporations. Both the corporation and the owners may be required to recognize gains.

Treas. Reg. §§ 301.7701-3(f) and (g), effective November 29, 1999, describe how some entities will be treated for federal tax purposes once they elect to change their classification. These subsections have not been adopted by Cal. Code Reg. § 23038(b)-3. For example, under the regulations, an association that elects to be classified as a partnership is deemed to liquidate by distributing its assets and liabilities to shareholders. Shareholders are then deemed to contribute all of the distributed assets and liabilities to the partnership. In contrast, a partnership that elects to be classified as an association is treated as having contributed all of its assets and liabilities to the association in exchange for stock in the association. The partnership is then treated as liquidating by distributing stock in the association to its partners. The regulations also address the effects of a classification change on a business entity that has a single owner. Any entity that has a tax identification number will retain that number if its federal tax classification changes under Treas. Reg. § 301.7701-3. For franchise tax purposes in California, use the 12-digit Secretary of State identification number.

Revenue Rulings 99-5, 1999-1 C.B. 434, and 99-6, 1991-1 C.B. 432, further explain the tax consequences when single member entities classified as disregarded entities become multi-member entities classified as partnerships, and vice versa. Revenue Ruling 99-5 addresses the acquisition of a partial interest in a single owner LLC, and Revenue Ruling 99-6 addresses the acquisition by one person of a multi-member LLC. The method of acquisition of the membership interest determines the tax consequences.

Disregarded Entities

The nature of the disregarded entity is unique. Transactions between the single-member LLC and its owner will be disregarded for tax purposes, but transactions between the LLC and a non-owner will be treated as if they occurred between the LLC and the third party. For example, if a third party makes a loan to an LLC that is a disregarded entity, only the LLC is responsible for the debt. If the owner of the disregarded entity makes a loan to the LLC, there is no debtor-creditor relationship for federal tax purposes. Owner loans to or from a disregarded entity will not create separate debt.

Although a single member LLC may be disregarded, Rev. & Tax. Code sections 17941 and 17942 impose a tax and fee on LLCs that elect to be taxed as disregarded entities. The tax is $800.00, and is due the 15th day of the fourth month of the taxable year, not at the end of the taxable year when the tax return is due. Disregarded entities also must file Form 568, pages 1 and 3.

Proposed Regulation 1.368-2(b)(1), released November 15, 2001, states that the merger of corporation and a disregarded entity is not a statutory merger qualifying as a tax-free reorganization under section 368(a)(1)(A). The transaction may be treated as a C, D, or F reorganization, if all necessary requirements are met, or as a section 351 transaction.

COMPARISON OF LLC TO OTHER ENTITIES					
	Limited Liability Company	**Limited Partnership**	**General Partnership**	**LLP**	**Corporation**
File documents with state	Yes	Yes	No	Yes	Yes
Governing instrument	Articles of Organization & Operating Agreement	Partnership Agreement	Partnership Agreement	Partnership Agreement	Articles of Incorporation & By-laws
Owner title	Member	Partner	Partner	Partner	Shareholder
Entity name	Name indicates limited liability	Name indicates limited liability	No requirement	Name indicates limited liability	Name indicates limited liability
Ownership restrictions					
# of owners	No upper limit. Some states require at least two members	At least two partners	At least two partners	At least two partners	No upper or lower limit for C Corps. S Corps limited to 75 shareholders
Type of owners	No restrictions	No restrictions	No restrictions	States may limit type of owner	No restrictions for C Corps. Significant restrictions on shareholders of an S Corp
Type of interest	No restrictions	No restrictions	No restrictions	No restrictions	No restriction for C Corps. Single class of stock for S Corps

COMPARISON OF LLC TO OTHER ENTITIES, cont'd.

	Limited Liability Company	**Limited Partnership**	**General Partnership**	**LLP**	**Corporation**
Liability for entity debts	No member is liable	General partners are liable	All partners are liable	Malpractice liability limited to self and those supervised.	No shareholders are liable. Liable for contractual debts in most states.
Participation in Management	All members may participate. Agreement can limit to selected managers.	General partners manage. Ltd ptrs don't.	All partners may manage. Can limit by agreement	All partners may manage. Can limit by agreement	Managed by officers and directors.
Transferability of interest	Significant restrictions placed on transfer	Significant restrictions placed on transfer	Significant restrictions placed on transfer	Significant restrictions placed on transfer	No restrictions
Dissolution events	All or a majority of remaining members must agree to continue in case of a dissolution event.	All or a majority of remaining general partners must agree to continue in case of a dissolution event.	All or a majority of remaining partners must agree to continue in case of a dissolution event	All or a majority of remaining partners must agree to continue in case of a dissolution event	No effect.

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NUTS AND BOLTS TOPICS

Doing Business (in California)

In the case of an LLC electing to be taxed as a corporation, the business itself, along with its income and dividends, does not subject a shareholder not otherwise doing business in the state to tax. Corporate law separates the business of a corporation from its shareholders.

In the case of a partnership, the partnership's business represents the instate aggregation of the business of the partners, each of whom is treated as the owner of a direct undivided interest in partnership assets and operations. This tenancy in partnership is fundamental to the underpinnings of state and local taxation of partnerships and partners. (See *Appeal of H.F. Ahmanson & Co*. Cal. Bd. of Equal. April 5, 1965.)

The treatment of a corporate member of an LLC that is treated as a partnership is identical to the treatment of a corporation that is a partner in a partnership. The treatment of a member of an LLC that is treated as a partnership is identical to the treatment of a partner in a partnership. This is because the LLC's income, assets, and activities flow through to the member.

Generally if an out of state member of an LLC, electing to be taxed as a partnership, is in the position of a general partner, the out of state member is considered to be doing business in California. (See *Appeal of Amman & Schmid Finanz AG*, 96-SBE-008.) As an example, the single member of a SMLLC doing business in California will also be considered as doing business in California. An LLC may be managed by all of its members, or one member. However, an LLC may also designate certain persons as managers and the manager need not be a member of the LLC.

Some examples:

1. LLC Invest is a limited liability company formed in a state other than California, has multiple members, and buys and sells securities. The managing member of LLC Invest is a California resident. The LLC Invest does not have an office in any other state; however, the managing member has an office in San Diego. The only business the managing member performs on behalf of the LLC is phone calls to sell or buy the securities. The instructions on Form 568, Section E, under "who must file", paragraph three, state that regardless of where the trade or business of the LLC is primarily conducted, an LLC is considered to be doing business in California if any of its members, managers, or other agents are conducting business in California on behalf of the LLC. It would be the same as if a general partner was

doing business in California for an out of state partnership. The partnership would be considered doing business in California because the general partner is doing business in California.

On the other hand, gross income of a nonresident member will not include dividends, interest, or gains and losses from an LLC qualified as an investment partnership that is doing business in qualifying investment securities in accordance with California Revenue and Taxation (Rev. & Tax.) Code § 17955.

LLC Invest is required to file an LLC return, Form 568, and pay the fees and minimum tax; however, if LLC Invest qualifies as an investment partnership that is generating income from qualifying investment securities, the nonresident members generally will not be taxed on this income. LLC Invest must inform its nonresident members or foreign members if all or a portion of their distributive share of income is from "qualifying investments securities" of an "investment partnership" and whether it is sourced to California. Thus, members' share LLC Invest income would not be considered California source for the nonresident members if 100% of their share was from qualifying investments securities of an LLC qualified as an investment partnership. Consequently, no tax would be paid by LLC Invest on behalf of its nonresident members.

2. A single member LLC (SMLLC) is formed in a state other than California, the single member is a California partnership, and the SMLLC is reported as a disregarded entity. The SMLLC buys and sells stock, and holds stock. The decisions regarding stock transactions are made by the California partnership. As a disregarded entity, the gain and loss of the SMLLC is included in the returns filed by the California partnership. Is the SMLLC "doing business" in CA. Section 17941 imposes a tax on every LLC "doing business" in California, as defined in Rev. & Tax. § 23101. California Code of Regulations, title 18, § 23101 states "This includes the purchase and sale of stocks or bonds,..." Making decisions regarding the sale of stocks and bonds may not by itself be doing business, but in this case the SMLLC has no presence other than that of the partnership. All records, transactions, etc. are in California. The SMLLC is doing business in California and subject to the annual tax and fee. The exception to the doing business rule in section 23102 for holding companies is limited to holding companies, and not applicable to this example.

The instructions on Form 568, Section E, under "who must file", paragraph three, states that regardless of where the trade or business of the LLC is primarily conducted, an LLC is considered to be doing business in California if any of its members, managers, or other agents are conducting business in California on behalf of the LLC.

3. A foreign limited partnership is a manager of a California LLC. California Corporations Code § 15611(ag)(2) states that a foreign limited partnership shall not be considered to be transacting intrastate business merely because it is a member or a manger of a domestic limited liability company. Similarly, California Corporations Code § 17001(ap)(2) states that a foreign limited liability company shall not be considered to be transacting intrastate business merely because it is a member or a manger of a domestic limited liability company. However, the foreign limited partnership, which is a manager of a California LLC, is liable for minimum tax. (See Rev. & Tax. Code § 17935.) Similarly, a foreign

limited liability company, which is a manager of a California LLC, is liable for minimum tax and fee. (See Rev. & Tax. Code §§ 17941 and 17942.) "Doing business", as used in Rev. & Tax. Code § 23101 is a broader concept than transacting business used in the Corporations Code, and in this fact pattern, the foreign limited partnership and the foreign limited liability company are acting as the general partners of the domestic LLC.

Fees and Taxes

Rev. & Tax. Code §§ 17941 and 17942 impose a tax and fee on LLCs that elect to be taxed as partnerships or as disregarded entities. The tax is $800.00, and is due the 15th day of the fourth month of the taxable year, not at the end of the taxable year when the tax return is due.

The fee is based on a sliding scale, depending on "total" income" and is due the date the tax return is due to be filed, without regard to any extensions.

Fee	Total Income
$900	$250,000 or more, but less than $500,000
$2,500	$500,000 or more, but less than $1,000,000
$6,000	$1,000,000 or more, but less than $5,000,000
$11,790	$5,000,000 or more.

With the adoption of these fees, there will no longer be an annual study and redetermination of LLC fees.

"Total income", used to determine the LLC Fee, is the total annual income from all sources reportable to California before any apportionment and allocation. Rev. & Tax. Code § 17942(b)(1) defines "total income" as gross income, as defined in Rev. & Tax. Code § 24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer[1].

On the other hand, "total income" shall not include allocation or attribution of income or gain or distributions made to a limited liability company in its capacity as a member of, or holder of an economic interest in, another limited liability company if the allocation or attribution of income or gain or distributions are directly or indirectly attributable to income that is subject to the payment of the fee described in Rev. & Tax. § 17942. In a tiered group of LLCs, each member has to pay the pay the

[1] Total Income on the Limited Liability Company Worksheet has an adjustment for cost of goods sold, adding cost of goods sold into the calculation. (See LLC Income Worksheet, line 18.) Treas. Reg. § 1.61-3 states that in a manufacturing, merchandising, or mining business, "gross income," means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Accordingly, it is necessary to add back cost of goods sold to determine the total annual income used to determine the LLC Fee.

minimum tax and the fee. However, once income is considered by an LLC in determining the correct fee, this income will not be included in total income and considered again in determining the fee, if distributed to a member that is also an LLC.

"Total income" also includes income such as interest and gains from the sale of property[2], gains from the sale of IRC § 1231 property, and capital gains, but not losses. Gross income includes income derived from business. (See IRC § 61(a)(2).) Business income includes business gains and losses. Therefore, net gain, but not losses from the sale of IRC § 1231 assets is also included in total income for purposes of determining the correct amount of total income for purposes of determining the correct LLC fee. Schedule D-1 is used to report sales of business property, including involuntary conversions and recapture amounts. The ordinary gains (not losses) and the recapture income from Schedules D-1, Part II, line 18and IRC § 1231 gains (not losses) included in schedules D-1 are included in the calculation of Total Income on the Limited Liability Company Worksheet, and entered on line Form 568, Side 1, line 1.

The computation of total annual income used to determine the LLC fee also includes capital gain from investment income, but not losses. (See worksheet, line 14c and schedule D (568), Capital Gain or Loss.)

The fee paid by an LLC is deductible on Form 568, and taken at the LLC level as other deductions. It is not considered a tax based upon income. It falls within the provision for deducting ordinary and necessary business expenses (IRC § 212 and Rev. & Tax. § 17201).

Nonconsenting nonresident members tax paid by the LLC does flow through to the members since it is an income tax paid to California. This amount is reported under credits, line 13e, Schedule K-1(568).

Forms

Unlike the IRS, the FTB has unique California forms for LLCs reporting as partnerships or as a single member LLC. For federal purposes, LLCs choosing to be taxed as partnerships file Form 1065, U.S. return of Partnership Income; LLCs choosing to be taxed as corporations file Form 1120, U.S. Corporation Income Tax return, LLCs choosing to be taxed as S corporations file Form 1120S, U.S. Income Tax Return; and disregarded entities report items of income and deductions on the applicable forms and schedules of the member's tax return.

The requirement for LLCs to file California tax returns is specified in Rev. & Tax. Code § 18633.5.

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[2] Rev. & Tax. Code § 24271 conforms to IRC § 61, except as otherwise provided. IRC § 61 defines gross income, and includes gains derived from dealings in property. Treas. Reg. § 1.61-6 is clear that gross income includes only the gain on the sale or exchange of property, not the gross sales price.

For California purposes LLCs choosing to be taxed as partnerships or as single member LLCs, disregarded entities, file Form 568, Limited Liability Company Return of Income, although the disregarded entity need only file pages 1 and 3. LLCs are required to prepare the Sch K-1s for all members even if these members are other business entities.

LLCs choosing to be taxed as a partnership, not doing business in California but receiving California source income, file Form 565.

LLCs choosing to be taxed as corporations file Form 100, California Corporation Franchise Tax Return, or Form 100S, California S Corporation Franchise Tax return.

The Franchise Tax Board accepts federal Form 8832, Entity Classification Election, as notice that an LLC has elected to be taxed as a different type of entity for both federal and California state purposes. The form should be attached to its California return for the year in which the election is effective.

Members

California Corporations Code § 17001 defines member, and person, in broad terms. A husband and wife may be considered as two members or as a single member of an LLC, depending on the structure of their membership. Form 568 Booklet, page 12 schedule K-1, " If a husband and wife each had an interest in the LLC, prepare a separate Schedule K-1 (568) for each spouse. If a husband and wife hold an interest together, prepare a single Schedule K-1 (568) since they are considered to be one member."

Further the IRS has determined that a single member LLC may have more than one member in certain situations.

-Use in IRC § 1031 exchanges;
see PLR 199911033 (grantor trust), PLR 9807013, PLR 9751012, PLR 2000118023

-Use in IRC § 10033 involuntary conversions;
see PLR 199945038, PLR 199909054

-Disregarded Members;
see PLR 199915030, PLR 200008015, PLR 200107125

-No Membership Interest
PLR 199914006

Short Year Returns

Rev. & Tax. Code § 18633.5 provides filing requirements for limited liability companies, whether choosing to be taxed as partnerships, corporations, or disregarded entities.

The issue of the short year return, and the payment of the tax and, comes up in the context of a change in classification of an LLC. For example, an LLC changing from being taxed as a corporation to being taxed as a partnership, or from being taxed as a partnership to being taxed as a disregarded entity. The LLC remains the same, but must file short year tax returns for each taxable classification. Rev. & Tax. Code § 18633.5 refers to taxable year, and Rev. & Tax. Code §§ 17010 and 23041 both include periods of 12 months or less in the definition of taxable year. For LLCs taxed as partnership or disregarded entities, the $800 annual tax is imposed for each short taxable year and the fee is based on the total income reported for each short year return.[3]

An example. An LLC chooses to be taxed as a partnership. More than 50% of the partnership interests are transferred. The partnership, but not the LLC is terminated and must file a short year partnership return as of the date more than 50% of the partnership interests are transferred, using Form 568. The LLC itself does not change but now has different partners. A Secretary of State Form LLC-1A is not required and the LLC doesn't have to file any forms with the Secretary of State. The partnership is also required to file a short year return for the remainder of the taxable year, up to the end of the taxable year.

The annual $800 tax is paid with the short year for both the old and the new partnership (two payments of $800 each) because the minimum tax is based on tax year, not annually. See Form 565 line 23. The $800 minimum tax is imposed for each taxable year. and the $800 tax must be paid with each short year return.

The fee is computed based on the total income of each short year return because the fee is computed from the beginning of the taxable year to the close of the LLC's taxable year. Since the LLC taxed as the old partnership will have ended its taxable year early, it will have to compute the fee based on its total income up to the date it files its final return. Similarly, the LLC taxed as the new partnership will have to compute the fee based on its total income from the beginning of the short taxable year to the close of the LLC's taxable year.

For California purposes, the time period when a partnership must file its California tax return, Form 565, will be the same as that required by the IRS. Form 565 references the instructions for federal Form 1065. Similarly, the time period when an LLC, which reports for tax purposes as a partnership, must file its CA tax return, form 568, also will be the same as that required by the IRS for a partnership. Form 568 also references the instructions for federal Form 1065, at page 6, paragraph J.

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[3] Rev. & Tax. Code § 17941 refers to "shall pay annually", referencing the $800.00 tax. Rev. & Tax. Code section 17551 conforms by reference to a number of sections of the IRC, including section 441. This section defines taxable year and annual accounting period to include the period for which the return is made, if a return is made for less than 12 months. Accordingly, the tax of $800.00 is due with each short year return for LLCs choosing to be taxed as partnerships or disregarded entities.

Nonresident Members

Rev. & Tax. Code § 18633.5(b), (c), (d), and (e), provide specific rules and requirements for nonresident members of LLCs choosing to be taxed as partnerships. Generally, the tax return for an LLC choosing to be taxed as a partnership must contain a listing of members, and an agreement from nonresident members to pay California tax on the distributions. If an agreement is not attached, the LLC must pay the California tax liability for the nonresident members.

Attaching a completed CA Form 3832 to the Form 568 will satisfy the requirement to include the names, addresses, and taxpayer identification numbers of the persons, whether residents or nonresidents, who would be entitled to share in the net income if distributed and the amount of the distributive share of each person. Form 3832 also provides the agreement of each nonresident member to file a California tax return, to make timely payment of all taxes imposed on the member by this state with respect to the income of the LLC, and to be subject to personal jurisdiction in this state for purposes of the collection of income taxes, together with related interest and penalties, imposed on the member by this state with respect to the income of the LLC.

If the LLC fails to timely file the agreements on behalf of each of its nonresident members, then the LLC shall pay to this state, on behalf of each nonresident member for whom an agreement has not been timely filed, an amount equal to the highest marginal tax rate in effect under Rev. & Tax. Code § 17041, in the case of members, which are individuals, estates, or trusts, and Rev. & Tax. Code § 23151, in the case of members, which are corporations, multiplied by the amount of the member's distributive share of the income source to the state reflected on the limited liability company's return for the taxable period.

Rev. & Tax. Code § 18633.5 requires nonresident members to sign Form 3832 (consent to be taxed by California). If such member is a partnership, a representative for the entity identified on the K-1 should sign the Form 3832. If a partnership is a member of an LLC, then the general partner should sign the consent to be filed by the LLC and is sufficient.

Nonconsenting nonresidents members tax paid by the LLC does flow through to the members since it is an income tax paid to California. This amount is reported under credits, line 13e, Schedule K-1(568).

Exempt Organizations

Rev. & Tax. Code § 23701 allows the Franchise Tax Board to exempt organizations, both corporations and unincorporated associations, from taxes imposed under Part 11, Division 2, Corporation Tax.

Generally, the Internal Revenue Service does not require an SMLLC, with the single member being an organization previously granted exemption from tax in accordance with IRC § 501(c), to apply separately for a determination of tax-exempt status. (See Announcement 99-102, 1999-43 I.R.B. 1; PLR 200134025.)

Rev. & Tax. Code §§ 17941 and 17942 impose a tax and fee on LLCs that elect to be taxed as partnerships or as disregarded entities. Sections 17941 and 17942 are included within Part 10, Division 2, Personal Income Tax. If an entity is a disregarded entity, there is no authority for the Franchise Tax Board to grant exemption from the tax and fee imposed by sections 17941 and 17942. However, an LLC that elects to be classified as an association for federal and California tax purposes is taxed as a corporation subject to the California corporation franchise tax, and is not subject to the tax imposed by Rev. & Tax. Code § 17941, or the fee imposed by Rev. & Tax. Code § 17942.

The staff of the Franchise Tax Board may grant exemption from franchise tax to unincorporated associations. For California franchise and income tax purposes, the federal classification of a business entity that is not classified as a corporation is controlling and must be the same. Therefore, every LLC and SMLLC, applying for exemption from franchise tax will be considered an association, if the LLC or the SMLLC has also elected to be classified as an association for federal tax purposes. Accordingly, the Franchise Tax Board may grant an exemption from franchise tax to an LLC or a SMLLC, with the single member being an organization previously granted exemption from tax in accordance with Rev. & Tax. Code § 23701 and another specific section within Article 1, Chapter 4, Part 11, only if the LLC and SMLLC have elected to be classified as an association for federal tax purposes.[4]

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[4] Because Corporations Code § 17002 allows limited liability companies to. "engage in any lawful business activity, except the banking business, the business of issuing policies of insurance and assuming insurance risks, or the trust company business", it is doubtful that an LLC will be able to qualify for exemption as a charity, educational, religious institution, in accordance with section 23701d.